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Expert Q&A: SPACs and Real Estate

by Practical Law Real Estate

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An Expert Q&A with Joshua N. Korff and David L. Perechocky of Kirkland & Ellis LLP on using special purpose acquisition companies in the real estate industry.

Special purpose acquisition companies (SPACs) have become an increasingly popular vehicle for raising money in the capital markets world, breaking records in fundraising activity during the last several years.

Practical Law asked Joshua Korff and David Perechocky of Kirkland & Ellis LLP to discuss the use of SPACs in commercial real estate. Josh represents private equity sponsors and public companies in connection with all forms of capital markets transactions, primarily focusing on high-yield and acquisition finance, initial public offerings (IPO), and complex restructuring matters. David's practice primarily focuses on public and private company mergers and acquisitions and general corporate and securities law matters and he has extensive experience working with REITs and other real estate companies. Both Josh and David advise on business combination transactions involving SPACs.

What is a SPAC?

A SPAC is a shell company formed by a sponsor to raise capital in an IPO to consummate a business combination with a to-be-identified private target company. The SPAC has no commercial operations until the consummation of a business combination and does not begin searching for a target company until after the IPO. The sponsor's investment experience, reputation, and network generally enable it to identify viable target companies. IPO investors typically choose to invest in the SPAC based on the sponsor's track record and experience. The investors' money is held in a trust account until either the business combination closes or the SPAC liquidates.

Once the SPAC signs and announces a pending business combination, it discloses extensive information about the deal and the target company, the deal is submitted to a vote of the SPAC's shareholders, and the SPAC's shareholders are given a redemption right, allowing them to receive their money back at the IPO price (plus any earned interest) if they do not like the deal.

If the business combination closes, the private target company merges with the SPAC and becomes a publicly traded company. If the SPAC cannot consummate a business combination within a specified timeframe (typically two years) it then liquidates and the IPO investors receive their money back at the IPO price (plus any earned interest).

What does the current SPAC market look like?

Although SPACs have been around since the early 1990s, the SPAC market experienced a significant boom beginning in 2020 and into 2021. According to information gathered by Kirkland & Ellis from DealPointData and PrivateRaise, in 2020, 248 SPACs filed IPOs seeking $75 billion of proceeds. In 2021, 610 SPACs filed IPOs seeking $147 billion of proceeds. In contrast, during 2017 through 2019 combined, only 139 SPACs filed IPOs seeking $31 billion of proceeds.

Similarly, SPAC M&A experienced a corresponding boom during the last two years as well. In 2020, 97 deals were announced with an aggregate value of $157 billion. In 2021, 267 deals were announced with an aggregate value of $600 billion. In contrast, during 2017 through 2019 combined, only 70 deals were announced with an aggregate value of $62 billion.

Although the number of SPAC IPO filings dramatically started to slow down beginning in April 2021 (evidenced by the fact that 49% of the SPAC IPOs filed in 2021 were filed in the first quarter), SPAC M&A continues to be strong.

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Are there any potential roadblocks to continued growth in the SPAC market?

Several trends may potentially hamper continued growth in the SPAC market, including increased regulatory scrutiny from the SEC, more pervasive shareholder litigation, softening demand among investors, and difficulties identifying viable IPO-ready target companies. The number of SPAC IPO filings began to decrease significantly beginning in April 2021. Much of that slowdown was due to a change in the SEC's position on the proper accounting treatment for SPACs. This is a technical issue that still forced several SPACs to restate or amend previous SEC filings and resulted in delays in IPOs and SPAC M&A transactions.

How long have SPACs been used in the real estate industry and why is it currently a big trend?

SPACs and real estate potentially cross over in three ways:

- Real estate investors sponsor SPACs.
- SPACs acquire businesses in the real estate industry.
- SPACs acquire businesses that serve the real estate industry or are otherwise "real estate adjacent" (for example, property technology businesses, which address the usage of technology and software to assist in today's real estate needs, commonly known as proptech).

This has been true throughout the history of SPACs but picked up during the 2020 and 2021 SPAC boom, particularly as prominent investors outside the SPAC world gained an interest in SPACs.

Real Estate Investors Sponsoring SPACs

Several established real estate investors and real estate companies have sponsored SPACs during the last two or three years. These include:

- Ares Management.
- CBRE.
- The Chera family.
- Tal Kerret (Silverstein Properties).
- Howard Lutnick (Cantor Fitzgerald).
- Spencer Rascoff (Zillow).
- Scott Rechler (RXR Realty).
- Simon Property Group.
- Barry Sternlicht (Starwood Capital).
- Tishman Speyer.
- Sam Zell (Equity Group).

Some of these SPACs focus on real estate or real estate adjacent target companies, while some focus on industries unrelated to real estate (such as tech, energy, and healthcare).

SPACs Acquiring Real Estate Businesses

Some SPACs may seek to acquire businesses in the real estate industry. However, the number of real estate businesses that have been acquired by SPACs is relatively small and the examples in this category are typically not traditional brick and mortar real estate portfolio companies. Examples of completed business combinations in the real estate industry include:

- Better.com (online lender).
- Landsea Homes Incorporated (homebuilder).
- Sonder (short term apartment rentals).
- Ucommune Group Holdings Limited (flexible office space provider in China).
- United Wholesale Mortgages (wholesale mortgage originator).
- WeWork (flexible office space provider).

SPACs Acquiring Real Estate Adjacent Businesses

Several SPACs seek to acquire proptech businesses, businesses that serve the real estate industry, or other "real estate adjacent" businesses. There are several examples of business combinations in this category, including:

- Doma (title company).
- Latch (building SaaS).
- Matterport (virtual site tours).
- Offerpad (home sales).
- Opendoor (home sales).
- Porch.com (home services).
- SmartRent (smart home products).
- View (smart windows).

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There are also examples of non-real estate operating companies with a large real estate component that have merged with SPACs, such as BurgerFi (fast food) and Cano Health (senior medical centers).

One of the reasons some SPACs have focused on proptech and real estate adjacent businesses is likely tied to the surge of interest in proptech among investors generally. SPACs commonly focus on technology companies or other high growth businesses and proptech fits within this framework. There are many proptech companies that have raised venture capital and growth equity investments in the last few years that are ripe for the next level of growth. SPACs can provide an effective means for late-stage growth companies to raise additional investor capital and go public at the same time.

What are the advantages of using a SPAC?

From the target company's perspective, a SPAC provides several advantages, including:

- Offers a path to becoming a publicly traded company that is generally faster and less expensive than a traditional IPO.
- Similar to an IPO:
  - the structure is flexible in that target shareholders typically roll their interests into the post-closing company and retain management control, but they can also choose to cash out some or all of their holdings. Different pricing mechanics can also be built into the structure. For example, parties can agree on earn-out consideration based on specified triggers, including post-closing stock price targets or future events; and
  - provides the target company with a large cash infusion, which can be used to pay down debt, fund capital expenditures or operating costs, or increase balance sheet cash reserves.
- Enables the parties to agree on a set valuation up front, providing pricing certainty, in contrast to an IPO where the valuation is only determined after the IPO is launched.

From the SPAC sponsor's perspective, a SPAC provides the sponsor with a platform to raise capital from the public markets and execute on M&A transactions using a well-known playbook. A sponsor can form a SPAC with relatively limited upfront capital. If the SPAC consummates a business combination the sponsor has significant upside in the form of sponsor promote shares and warrants. If a SPAC combines with a real estate company, the assets are also relatively easy to value (unlike technology companies and other companies with a significant amount of intangible assets), enabling the SPAC to more confidently and accurately determine the appropriate valuation for the target company.

Another advantage of a SPAC is the concurrent private investment in public equity (PIPE investment) that accompanies most SPAC transactions. In a PIPE investment, the SPAC and the target company management seek commitments from other investors to invest in the combined company at closing. The capital raised from the PIPE investment increases the amount of cash available at closing, counteracts potential redemptions from the IPO investors, and, because the PIPE investors are often large, well-known institutional investors, signals to the public markets that sophisticated investors support the deal at the agreed-on valuation. The PIPE investors, together with the SPAC sponsor, provide the target company with a stable of key investors and advisors, which can provide ongoing support during the next stages of the company's life cycle.

Are there any drawbacks to using a SPAC?

There are a few commonly cited drawbacks to using a SPAC, which apply across industries, including:

- The target company shareholders experience dilution because the SPAC sponsor is entitled to a promote in the form of founder shares and warrants.
- The cash available at closing is uncertain given the potential for IPO investors to redeem their shares. This can impact the target company's ability to de-lever, fund anticipated capital expenditures, or otherwise increase available balance sheet cash.
- The timeline of a SPAC transaction is often compressed and moves more quickly and with fewer hurdles than a traditional IPO. While this can be a benefit for target companies looking to become public in an efficient manner, there is a risk that SPAC targets may be brought to market before the target company has an established public company compliance function that can effectively handle SEC reporting requirements, internal auditing controls, investor relations, and other matters. If brought to market too early, target company management may face undo stress and the post-closing stock price may be negatively impacted.

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- There is a risk that financial and business due diligence may be undertaken with less rigor than in a traditional IPO, where underwriters lead a comprehensive due diligence process. This may lead to the discovery of diligence issues after closing, resulting in investor lawsuits, restatements of financial reports, governmental investigations, or reputational harm to the target, the SPAC sponsor, or key investors.

Can a SPAC own real estate?

Yes, a SPAC can own real estate. A SPAC may merge with a REIT, a real estate company, a portfolio of real estate assets, or a non-real estate operating company that owns real estate as part of its business, like a health care company that owns medical offices or a manufacturing company that owns factories. Companies acquired by SPACs may seek to qualify as a REIT after closing. For more information on REITs, see Practice Note, REITs: Overview.

A SPAC transaction can also be structured as a tax-deferred "Up-C," which is similar to the UPREIT structures used by REITs. An Up-C structure enables target shareholders to receive partnership units in a subsidiary of the SPAC and carry over their tax basis in the target shares. The partnership units are exchangeable for shares of the SPAC at the holder's election, at which time the holder can recognize the deferred taxable gain. This structure, which is common in the REIT industry, offers a tax-efficient solution for the owners of the target company. This can be particularly valuable in the real estate industry where owners may have significant embedded taxable gains in the properties built up during many years of depreciation. This structure also enables the post-closing company to issue partnership units in connection with future acquisitions and offer the sellers in these future transactions a tax-deferred currency. For more information on Up-C structures, see Practice Note, UP-C Initial Public Offering Structures: Overview.

Are there certain asset classes that lend themselves more to using a SPAC?

SPACs tend to focus on companies in high growth industries. As noted above, proptech and other companies that provide services to the real estate industry are often good candidates for SPAC transactions. Certain real estate asset classes that are connected to technology or that offer higher growth prospects, such as data centers, cell towers, gaming and leisure, and certain types of industrial, infrastructure, and health care assets may also be suitable SPAC targets. There have also been examples of SPAC transactions involving residential lending platforms and short-term, flexible apartment and office space leasing.

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